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Report to the Chairman, Subcommittee on
Commerce, Consumer, and Monetary
Affairs, Committee on Government
Operations, House of Representatives

January 1989

BANKING

Conflict of Interest Abuses in Commercial Banking Institutions



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The new
efforts to



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General Accounting Office
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General Government Division

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January 27, 1989

The Honorable Doug Barnard, Jr.
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to your request, this report provides information on conflicts of interest in commercial banking institutions. Specifically, the report discusses current institutional conflicts of interest abuses in commercial banking, and factors controlling conflicts and limiting abuses. This report also discusses a possible increase in institutional conflicts of interest and the potential for abuse if banking institutions are granted expanded securities powers.

As arranged with the Subcommittee, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will make copies available to other interested parties upon request. The major contributors to this report are listed in appendix VIII.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Craig A. Simmons' with a stylized flourish at the end.

Craig A. Simmons
Senior Associate Director

Executive Summary

Purpose

In the ongoing debate over whether banking institutions should be given expanded powers, there are concerns that banks, faced with new opportunities to improve their own financial condition or that of favored customers, might abuse the interests of customers or the federal deposit insurer. As a justification for denying expanded powers, critics of bank expansion cite conflict of interest abuses that occurred when no restrictions separated banking and securities activities.

The Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations requested GAO to provide information to

- identify current types of conflicts of interest and associated abuses through which commercial banking institutions may benefit themselves, so-called institutional conflicts of interest and abuses;
- determine how such conflicts are controlled to prevent their abuse; and
- provide insight into potential conflicts of interest and abuses if banking institutions are granted expanded securities powers.

Background

A conflict of interest is a situation in which a person or business serving more than one interest can benefit by favoring one interest at the expense of others. Conflict situations occur during the normal course of many business operations, including banking. While the presence of such situations in banking is neither inherently wrong nor necessarily illegal, the abuse of such situations is.

An abuse of a conflict of interest occurs when a bank or its representative takes advantage of a conflict situation in violation of customary banking practices, fiduciary responsibilities, or banking laws and regulations. As industry practices and banking laws and regulations change, the definition of an abuse continues to evolve.

Regulatory oversight of commercial banking institutions is done by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, as well as by state banking regulators. (See pp. 43 to 53.)

Results in Brief

Although the opportunity to abuse conflicts of interest exists in banking, the consensus view among those bankers, regulators, and legal and academic experts GAO interviewed was that institutional conflict situations are currently well-controlled. In their view, while instances of abuse

may occur, institutional abuses are not a widespread problem. While not the focus of this report, personal abuses, including self-dealing and fraud, have been a contributing factor in many bank failures.

According to those interviewed and a review of relevant literature, three factors currently work to control institutional conflicts of interest and limit their abuse: competition, banking internal controls, and regulatory oversight.

Expanded securities powers for banking institutions would increase the diversity of banking operations, thus increasing the potential for conflicts of interest. However, the consensus view of those bankers, regulators, and legal and academic experts GAO interviewed was that an increase in conflict situations would not necessarily lead to additional abuses.

Those interviewed believed that the existing control mechanisms, with some adjustments, would generally be sufficient to control conflict situations and limit their abuse. However, since it is not possible to know in advance the potential for future abuses, the expansion of banking institutions' securities powers warrants active oversight by regulators.

GAO's Analysis

GAO interviewed a judgmental sample of bankers, federal and state banking regulators, and legal and academic experts to obtain their perceptions of institutional conflicts of interest and abuses, mechanisms to control conflicts and limit abuses, and perceived effects on conflicts of interest and potential for abuse of expanded securities powers. The sample, while not statistically representative, included bankers and regulators likely to be involved in expanded securities powers. (See pp. 13 to 14.)

Conflicts of interest are common in banking, as they are in many businesses. GAO found that conflicts of interest faced by banking institutions could be grouped into three categories: conflicts with customers, conflicts with stockholders and creditors, and conflicts with the deposit insurer. A banking institution could abuse a conflict of interest with customers, for example, by promoting products and services of the bank and its affiliates that are not in the best interest of the customer when providing supposedly objective investment advice. (See pp. 8 to 12.)

For the most part, bankers, regulators, and experts interviewed agreed that, while instances of institutional abuse may occur, they are not

widespread throughout the banking industry. In a review of selected federal bank examination reports, GAO found the reports did not reveal indications of widespread abuse. Consumer complaint data was of limited usefulness in assessing the extent of institutional conflict of interest abuses; for example, it is difficult to determine if a complaint involved a conflict of interest. (See pp. 23 to 26.)

While personal abuses were not the focus of this report, some regulators and experts interviewed by GAO expressed concern about such abuses. In a recent study, the Office of the Comptroller of the Currency found that the incidence of insider abuses in failed banks exceeded 50 percent and contributed to one-third of national bank failures. Preliminary findings from a GAO study of bank failures during 1987 also indicate a high incidence of insider abuses. (See pp. 23 to 25.)

Conflicts of interest may increase as banking institutions gain expanded securities powers. Since a conflict of interest represents an opportunity for abuse, an increase in conflict situations would increase the opportunities for potential abuse. However, bankers, regulators, and experts interviewed by GAO generally agreed that the combination of competition, internal controls, and regulatory oversight, with adjustments, such as increased securities training and additional regulatory agency staffing, would be adequate to limit abuses of institutional conflicts of interest under expanded securities powers.

While this confidence was reassuring, the increasing potential for abuse that may accompany the expansion of securities powers for bank institutions requires the regulators to ensure that resources and procedures are adequate to exercise active oversight. (See pp. 27 to 31.)

Recommendations

GAO is making no recommendations.

Agency Comments

The Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency generally concurred with GAO's report (see apps. V, VI, and VII). The agencies made technical suggestions which GAO incorporated into the report where appropriate.

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Abbreviations

FDIC	Federal Deposit Insurance Corporation
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
REIT	Real Estate Investment Trust
SEC	Securities and Exchange Commission

Introduction

The Glass-Steagall Act generally separated commercial banking from securities activities.¹ The intent of the act was to enhance the safety and soundness of the banking system and to protect consumers from unfair banking practices, including conflict of interest abuses. In recent years, Congress, regulatory agencies, and the courts have allowed banking institutions (commercial banks and their holding companies) to expand into additional securities-like banking activities. As Congress considers whether banking institutions should be granted further securities powers, critics of bank expansion allege that banking institutions would take unfair advantage of customers, investors, and the federal deposit insurer by abusing conflicts of interest.

What Are Conflicts of Interest?

A conflict of interest occurs when a person or business serving more than one interest can potentially benefit by favoring one interest at the expense of the others. In banking, and indeed in many other businesses, conflicts of interest arise in the normal course of operations. In many cases, the presence of such conflict situations is neither inherently wrong nor necessarily illegal. However, a conflict situation represents an opportunity for abuse.

Difficulties in Defining a Conflict of Interest Abuse

In our attempts to define an abuse of a conflict of interest, we found what constitutes an abuse largely depends upon what is considered to be proper behavior. There is a large body of law, including statutes, regulations, and established fiduciary principles, which defines acceptable behavior with regard to various conflicts of interest which may arise in banking. Violation of these laws constitutes a conflict of interest abuse. In addition, market practices have also developed to define parameters for acceptable behavior.

We consulted bankers, regulators, and academic experts to determine the underlying rationale both for current law and accepted market practices and for future law and developing market practices. We found that while market efficiency is often the underlying rationale, this is not always the case.

Laws and regulations may codify what has already become standard industry practice. Practices that promote the efficient operation of markets often become standard within an industry because they reduce

¹Sections 16, 20, 21, and 32 of the Banking Act of 1933, 12 U.S.C. 24, 377, 378, and 78, respectively.

costs for firms and consumers and increase the benefits from transactions. However, market practices may not always promote efficiency, especially when competition is lacking. In these cases, laws and regulations may intervene to disallow these practices. Therefore, efficiency is one criterion that can be used in considering whether a practice may be abusive. However, laws and regulations may also explicitly favor the interests of one group, such as consumers, over the interests of others, sometimes conflicting with market efficiency. Accordingly, no single criterion defines an abuse in all cases.

For our purposes, we have defined an abuse of a conflict of interest as occurring when a banking institution or its representative takes advantage of a conflict situation in violation of fiduciary responsibilities, customary banking practices, or banking laws and regulations. Such abuses may include misuse of client assets, improper financial advice, or misuse of material, nonpublic information.

Abuses can benefit the banking institution or an individual. In this report, we are focusing on those abuses benefiting the bank itself, so-called “institutional abuses.” We include discussion of personal abuse when it adds to the understanding of how bankers and their regulators view institutional abuses.

The continuously changing nature of banking further complicates the search for a precise definition of an abuse of a conflict of interest. Banking institutions currently offer products and services which were not envisioned just a few years ago. As the market changes, what is considered by market participants to be an abuse also changes. Furthermore, changes in banking practice may be followed by changes in laws and regulations to limit or prohibit certain behavior or activities. Changes in what are considered to be abuses may also result from litigation in state and federal courts. Thus, the definition of conflict of interest abuses tends to evolve with changing circumstances.

The federal banking regulators do not have a general policy definition for either a “conflict of interest” or an “abuse” of a conflict. Instead, the regulators cite specific banking practices that have been prohibited or limited by existing laws and regulations. For example, examination manuals instruct examiners to look for unacceptable practices, such as product tie-ins or credit extensions to affiliates in excess of allowable limits.

An example illustrates how the definition of an institutional conflict of interest abuse may change or evolve. In the past, some banks which managed employee benefit funds charged separate fees for transferring a fund's cash into interest bearing accounts managed by the bank. The U.S. Department of Labor issued a ruling forbidding separate fees for such transactions. Thus, a previously accepted banking practice became an abuse as a result of regulation.

Types of Conflicts of Interest

In view of the lack of a common definition or generic description of an abuse, specific examples illustrate the nature of institutional conflicts of interest and their abuses. We found that these examples could be grouped into three broad categories: conflicts with customers, conflicts with stockholders and creditors, and conflicts with the federal agencies that insure bank deposits. Appendix I contains examples of institutional conflicts of interest that we identified through interviews and literature reviews.

Conflicts With Customers

A banking institution and its employees routinely encounter situations in which their interests would be better served by actions not in the best interest of the customer. This may occur when the banking institution has a "salesman's stake" in promoting products or services while at the same time purporting to provide disinterested or objective advice. For example, the banking institution or its employees could abuse such a situation by buying or selling securities or advising customers for the purpose of assisting the bank's own trading, marketmaking, or underwriting activities. In addition, the banking institution could abuse a customer's interests by misusing confidential information provided by the customer, requiring the customer to purchase additional products or services, or giving preferred treatment to certain customers.

Conflicts With Stockholders and Creditors

A banking institution may abuse a conflict of interest at the expense of stockholders or creditors. In general, this conflict occurs in a business or organization where the interests of the managers are not the same as those of the owners. For example, when managerial compensation is tied to current profits, managers may take a course of action which increases short-term profits at the expense of longer term total profits. A banking manager might approve loans with high up-front fees but poor long-term prospects for repayment. Further, the interests of both managers

and owners may well differ from those who lend to the banking institution, such as bank depositors or those holding the debt of the bank holding company.

The existence of affiliates within a bank or bank holding company structure may generate conflict situations if the affiliates have different capital and ownership structures than the parent bank or bank holding company. For example, if the stock of the bank and an affiliate are not owned in the same proportion by the same stockholders, the controlling stockholders or the managers may have an incentive to take actions detrimental to the interests of the other stockholders. In addition, an incentive may exist for managers to favor the interests of the affiliate(s) within which the parent has more invested, especially in times of stress. In such conflict situations managers could, for example, make imprudent or unsound loans to an affiliate, transfer bad assets from the affiliate to the bank, or require the bank to purchase services from the affiliate at inflated prices.

Conflicts With the Deposit Insurer

Deposit insurance is provided to strengthen deposit holders' confidence in the safety and soundness of the banking system by protecting them against losses.² At the same time, depositors are relieved from having to personally oversee the bank's activities since they know their funds are protected in the event of a failure. In the place of depositors, the deposit insurer is exposed to "moral hazard," that is, the risk that the banking institution may behave to increase its own return while increasing the risk to the insurer. Specifically, a banking institution may have an incentive to increase its possible return by engaging in high-risk activities with its depositors' funds, particularly after its own capital has been dissipated since it knows that depositor losses will be covered by the deposit insurance. With riskier assets, the bank or holding company owners receive any increased gains, while the deposit insurer bears all increased losses exceeding the bank's capital.

To illustrate conflicts with the deposit insurer, critics of bank expansion cite the 1970s experience of real estate investment trusts³ (REIT) and the October 1987 instance of Continental Illinois Bank's lending over imposed limits to a subsidiary. Bank holding companies, with the Federal Reserve's qualified approval, sponsored their own REITs. When the

²Currently, deposits are federally insured up to \$100,000 per account per bank.

³A real estate investment trust is a mutual fund whose portfolio is comprised of loans and investments in real estate.

real estate market weakened in the 1970s, some banks attempted to help bail out the struggling REITs. Critics claim this situation weakened the banks, leaving them more vulnerable to failure and increasing the risk to the deposit insurer. In October 1987, during the Stock Market Crash, Continental Illinois Bank extended \$384 million, exceeding limits imposed by OCC (Office of the Comptroller of the Currency),⁴ to rescue its options subsidiary. Again, critics claim that this increased the risk to the bank and to the deposit insurer. On the other hand, OCC sees the Continental Illinois situation as an example of a regulator restricting a bank's activity and effectively enforcing these restrictions. (See pp. 50 to 51.)

Some critics of bank expansion assert that expanded securities powers would increase the opportunities for a banking institution to involve itself in activities that would increase risk to the federal deposit insurer.

Objectives, Scope, and Methodology

The Chairman of the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations requested that we provide information to

- identify types of conflicts of interest and associated abuses that currently exist in commercial banking institutions,
- determine how such conflicts are controlled and federally regulated to limit their abuse, and
- provide insight into the effects on potential conflicts and their abuses of expanded securities powers for banking institutions.

At the request of the Subcommittee, we focused on conflict of interest abuses that primarily benefit the banking institution rather than on the more widely recognized and discussed abuses by individuals, such as self-dealing and insider trading. We did our work between April 1987 and March 1988 in accordance with generally accepted government auditing standards. The three bank regulators from the federal government provided written comments on a draft of this report. Those comments and our evaluations are presented in appendixes V, VI, and VII.

⁴OCC chose to restrict the lending activity between the bank and its subsidiary to the limits contained in 12 USC 84, even though there is no regulatory limit applicable to transactions between an operating subsidiary and its national bank parent.

To identify conflicts of interest in banking and the controls over their abuse, we compiled the views of banking industry participants, regulators, and experts. We obtained these views from interviews; congressional hearing records; and publications prepared by banking institutions, their trade associations, regulators, and academic experts. Our interview sample, while not statistically representative, included bankers and regulators likely to be involved in expanded securities powers. Our sample was agreed to by the Subcommittee. Analysis results may not total to the number of interviewees in our sample since not all interviewees commented on all issues. An interviewee may not have commented due to no basis for comment, questioning outside area of expertise, or time constraints on an interview session.

Banking Institutions

We judgmentally selected both nationally and state-chartered banking institutions already involved in securities-type activities. The 22 banking institutions in our sample represented differing management styles and geographic regions. Specifically, we interviewed representatives of

- nine domestic commercial banks with multinational operations,
- ten domestic regional banks, and
- three U.S. branches of large foreign banking institutions engaged in universal banking with operations in the United States (the parent firms of these branches were granted extended activities under the grandfather provisions of the International Banking Act).

Federal and State Regulators

We interviewed headquarters and field officials of the three principal federal bank regulatory agencies—Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency. In interviewing field staff, we selected 16 field offices in the geographical areas where our sample banks were located.

Additionally, we met with eight state banking departments—California, Illinois, Massachusetts, New York, North Carolina, Ohio, Texas, and Virginia. They, like the field offices of the federal bank regulators, were selected because banks interviewed were under their jurisdiction.

Experts

We selected experts who had written extensively on the subject of conflicts of interest or were knowledgeable about the banking or securities industries. Appendix II lists the 29 legal, financial, and economic experts

employed by universities, government agencies, and industry that we interviewed.

Other Work

To identify the efforts of federal banking regulators to control conflicts of interest, we also studied policy guidance and procedures manuals of the Federal Reserve, FDIC, and OCC. We reviewed how the Federal Reserve addressed conflicts of interest when approving expanded powers for banking institutions. We reviewed budget documents from the three regulators for fiscal years 1985 to 1987 to attempt to determine the amount of staff time spent on controlling conflicts of interest and their abuses and on banking examinations in general.

We reviewed selected examination reports for the period between June 1984 and April 1987 for most of our sample banking institutions to determine if federal regulators have found indications of conflicts of interest abuses and to determine how conflicts of interest were addressed in federal examination reports. We did not, however, review workpapers associated with examination reports to determine whether testing for conflict of interest abuses was adequate.

For most banking institutions in our sample, we reviewed Federal Reserve reports of holding company inspections and commercial bank examinations, as well as OCC examination reports for subsidiary banks that were filed with the holding company reports. We also reviewed OCC examination reports for the international operations of domestic banking institutions in our sample. None of our sample banking institutions were examined by FDIC during the period under study, so we did not review any FDIC reports. In total, we reviewed a combination of 37 federal examination and inspection reports which covered 15 of the 19 domestic banks in our sample. We did not review examination reports for the three U.S. branches of foreign banks.

We also reviewed consumer complaint data from the FDIC, Federal Reserve, and OCC for the period of January 1985 to December 1987 to determine how federal regulators handled complaints and to determine if complaints indicated problems with conflict of interest abuses.

To obtain insight into whether conflicts of interest and their abuses would increase under expanded securities powers, we interviewed the bankers, regulators, and experts on their opinions.

Factors Controlling Conflicts of Interest and Limiting Abuses

According to literature reviewed and interviews with bankers, regulators, and experts, three factors work to control conflicts of interest and limit their abuse: competition, internal controls, and regulatory oversight. Competitive market forces serve as a significant deterrent against abuses of conflicts of interest. Internal controls in banking institutions serve to limit those abuses which could adversely affect a banking institution's competitiveness or harm the owners' interests. However, competition and internal controls are not always sufficient to limit all types of conflict of interest abuses. Regulatory oversight of the banking industry serves to further limit conflict of interest abuses.

Competition

According to bankers, regulators, and experts interviewed, competition serves as a significant deterrent to abuse of conflicts of interest. To maintain business relationships and profitability, banking institutions, for the most part, avoid the risk of adverse publicity and poor community and customer relations that could result from abusing conflicts of interest. Competition serves as a barrier to conflict of interest abuses as long as customers are aware when they are adversely affected by an abuse and can easily, upon becoming dissatisfied, take their business elsewhere or take legal action to protect their interests.

Customers and others doing business with banking institutions can protect their interests by gathering information about banking policies and operations at their own expense; by personally monitoring the banking institution's behavior; by placing contractual restrictions on the institution's behavior, or by taking their business elsewhere if dissatisfied. If a banking institution has abused their interests, injured parties can complain to the institution's regulator, report alleged violations to the local district attorney or other authorities, or sue for damages.

Also, a banking institution has an incentive to take actions which make it easier for its customers to protect their interests. To enhance its reputation, a banking institution may willingly disclose information to customers and implement internal controls to restrict the improper flow of information or funds. By protecting its customers' interests from potential abuse, a banking institution may gain a competitive advantage over rivals who do not, or avoid a competitive disadvantage to those rivals who do.

When competition is lacking or inadequate or when it is difficult or expensive for consumers to obtain necessary information, they may not be able to express dissatisfaction by taking their business elsewhere. In

addition, if the burden of litigation is prohibitive or if abusive behavior is likely to go undetected, consumers may not be able to obtain restitution when their interests are abused. In these circumstances, a banking institution may perceive an advantage to be gained by abusing the interests of customers or of other related parties, such as creditors or stockholders. In general, smaller, less sophisticated customers who are less able to bear the costs necessary to protect their interests are more vulnerable to abuses.

Internal Controls

In a competitive industry, the long-run profitability of a firm depends, in part, on limiting abuses of conflicts of interest. Policies and procedures are designed to limit inappropriate use of funds or exchange of assets and control the flow of information. We believe such control systems are critical since banks' primary asset, money, is liquid and particularly vulnerable to misappropriation. Further, banks possess highly sensitive and confidential information regarding customer finances. According to bankers, regulators, and experts, banking institutions use internal control systems to manage conflicts of interest and limit their abuses. Such internal controls include "Chinese Walls," codes of ethics, and internal audits.

Chinese Walls

"Chinese Walls" are an important component of a banking internal control system. These walls are intended to limit the passage of sensitive, critical, or confidential information within the bank's components and between the bank and affiliates, as well as limiting inappropriate transactions between units. The "bricks" of which these walls are constructed include regulatory and legal prohibitions, company policies and procedures, constraints on the access to both computerized and manual files, and even physical separations.

Without an adequate wall, unauthorized or unnecessary possession of information could unfairly give advantage to the banking institution or to one client at the expense of other clients. For example, information collected by a bank's mergers and acquisitions department could be used to influence investment decisions in the trust department, giving an unfair advantage to a customer or to the bank itself, at the expense of another customer.

The Chinese Wall concept has been used to insulate a bank's trust department. For example, trust departments may be physically separated from the other parts of the bank, on different floors or even in a

different building. Likewise, trust department personnel responsible for investing may be excluded from bank committees where credit matters involving nonpublic information are discussed. In today's banking structure, a Chinese Wall might also be found between the mergers and acquisitions unit and the rest of the bank.

Twenty of 22 banking institutions in our sample indicated that they had some form of Chinese Wall policy (two did not comment). The composition of a Chinese Wall is not the same in each banking institution. For example, one banking institution in our sample required the trust and commercial departments to be administered as "separate lines of business with careful control over the exchange of information and the treatment of customers." Another sample banking institution stated in its employee code of conduct that "confidential information coming to the Commercial Banking Division shall not be used by the Trust Division in making investments for fiduciary accounts." Still another banking institution protected confidential information by making the commercial lending area physically distinct from the trust division. While basic characteristics are common to all Chinese Walls, no single design or description fits the circumstances and needs of every banking institution. What is effective in one bank may be ineffective or unnecessary in another.

Code of Ethics

A code of employee ethics is another common element of an internal control system. A code of ethics provides guidance to banking employees on how they may effectively and fairly resolve conflict of interest situations. A code of ethics may also specify serious sanctions for abusive behavior. Moreover, to achieve competitiveness and long-term profitability, banking management may use a code of business conduct to create a shared set of institutional values.

All of the 22 banking institutions in our sample indicated that they had codes of ethics designed to specify appropriate employee conduct. According to one bank vice president, bankers believe that their organizations hold positions of trust in their communities and that it is essential that they and their employees do nothing to damage that. The bank official said banks were concerned about their reputation and the appearance of conflicts of interests. Accordingly, banking institutions may formally make such concerns known to employees through written codes of ethics and related training.

OCC officials indicated that the agency has actively encouraged all banks to adopt codes of ethics and provide related training to bank employees. These same officials said that over the past 10 years a large majority of commercial banks have created codes of ethics for their employees. The codes are important from the regulator's perspective as the codes set the standard for the entire banking institution. In response to Congress' 1986 amendment to the bank bribery statutes (P.L. 99-370), OCC along with the other federal bank regulators and the Department of Justice developed guidelines for bankers to follow to prevent bribery act violations and to create employee codes of ethics. OCC encouraged national banks to follow these guidelines. Additionally, OCC has been working with FDIC and the Federal Reserve to get similar codes of ethics adopted internationally.

Internal Audit

An internal audit unit, charged with enforcement of the company's policies and procedures, is also important in a bank's effort to limit abuses of conflicts of interest. An effective program serves to determine that internal controls and operating procedures function to minimize the possibility of losses due to inefficiencies, irregularities, and/or willful manipulation. A banking institution's external auditors, in planning the scope of their audit, may review the work plans and performance of the internal auditors' work.

Eighteen banking institutions in our sample indicated that they had internal audit units (four did not comment). According to regulators we interviewed, the likelihood of a banking institution having a full-time internal audit unit increases with the size of the bank. Bankers in our sample said that they rely upon their internal audit units to enforce appropriate policies and procedures and to identify problems within the bank. According to officials of eight banking institutions who commented, internal auditors are better able to identify potential abuses because they are more familiar with the bank's day-to-day operations than are regulatory agency examiners.

Regulatory Oversight

Banking laws, regulations, and supervision play an important role in controlling conflicts of interest and defining and limiting abuses, according to bankers, regulators, and experts. Laws and regulations serve to define and limit potential abuses by banking institutions, for example, through restrictions on banking institutions' activities, limits on transactions between banks and their holding company affiliates, prohibitions

against banking product tie-ins, and requirements that banking institutions disclose information to customers.

Banking supervision is comprised of regulatory monitoring and periodic examination to ensure banks operate prudently and in compliance with banking laws and regulations. Appendix III describes the regulatory oversight of the Federal Reserve, FDIC, and OCC. Maintaining the safety and soundness of the banking system is their primary objective, although federal banking regulators are also responsible for protecting the interests of bank depositors and promoting other social objectives. Federal regulators estimated that a majority of staff years is consumed in safety and soundness examinations. However, federal regulators were unable to estimate the examination staff time spent specifically to control conflicts of interest and detect abuses since the agencies do not maintain such statistics.

Evaluation of Banks' Internal Controls Is An Important Element of Banking Supervision

Evaluations and testing of banks' internal controls are one means through which federal regulators attempt to control conflicts of interest and detect abuses. While federal regulators do not have specific examination and supervision programs to identify conflict of interest abuses, the agencies' examination programs include procedures to address conflicts of interest. The regulators require that banking institutions have internal control systems which serve to control conflicts of interest and limit abuses. Regulators then verify that internal control systems are in place and operating properly. Steps to verify banking internal controls and detect abuses are incorporated throughout each agency's examination procedures.

While the bank regulators require that every banking institution have an internal control system and periodically evaluate that system, no single regulatory standard for the composition or structure of a bank's internal control system exists. According to the regulators, the design and implementation of internal controls, including Chinese Walls, are the responsibility of the institution's management. Since banking institutions vary in size, activities, and organizational structure, such controls vary from institution to institution and, indeed, within a given institution over time. Internal control systems may vary even among institutions with similar activities and organizational structures.

When entering a banking institution, examiners are to determine what internal controls exist, then study, document, and evaluate the institution's overall internal control system. The examiners are instructed to

determine if the system is adequate to protect the institution's assets and limit prohibited actions. Examiners generally test a sample of transactions to determine compliance with and enforcement of internal controls within the bank. Federal bank examiners then rely upon their evaluation of the effectiveness of a bank's internal control system in determining the nature, focus, and detail of their examinations. The results of these evaluations have a major bearing on the amount and type of additional work that an examiner may do. If it is determined that weaknesses exist in a bank's internal control system, the examiner is instructed to more closely scrutinize the banking institution's records.

Other Supervision Techniques May Not Detect Conflict of Interest Abuses

As a way of more efficiently using their current staffing levels, federal banking agencies are increasing their use of focused or limited scope examinations and off-site surveillance. Limited or targeted scope examinations focus on areas in the banking institution where examiners have reason to suspect that problems may exist. These examinations could be triggered by anomalies found during off-site surveillance or as a follow-up on findings from a previous examination. Depending on the banking activity under review, these narrowly focused examinations may or may not include steps addressing conflict of interest abuses.

Off-site surveillance involves monitoring of an institution's financial condition on the basis of financial reports provided to regulators by the bank. Routine financial reporting is useful in identifying threats to overall safety and soundness, such as inadequate capital or high proportions of risky assets. However, as currently structured, financial reports may not provide detailed information about day-to-day transactions necessary to detect some types of conflict of interest abuses. For example, current financial reports may not allow regulators to identify financial transactions that may result from customer favoritism.

How Banking Regulators Control Conflicts of Interest in Expanded Banking Powers

The Bank Holding Company Act of 1956 and amendments generally prohibit holding companies that own a bank from owning or controlling companies engaged in nonbanking activities. However, as the regulator for bank holding companies, the Federal Reserve may permit activities it determines are "closely related to banking" and would result in benefits to the public. Upon reviewing an application to undertake expanded banking powers by the holding company, the Federal Reserve may (1) permit the activity by regulation for all bank holding companies, (2) permit the activity by order for an individual bank holding company, or (3) deny the activity.

In its approval process for bank holding companies to undertake non-traditional activities, the Federal Reserve considers, among other factors, the need to control conflicts of interest when granting expanded powers. Before approving an activity by order for an individual bank holding company, the Federal Reserve may establish limitations, including internal controls over potential conflicts of interest, that the applicant must accept as a condition of approval. Federal Reserve examiners are then responsible for monitoring compliance with these limitations and controls when examining the bank holding companies.

In its consideration of limited securities activities by banking institutions, the Federal Reserve has cited several potential conflicts of interest. For example, the Federal Reserve questioned whether a holding company's subsidiary bank would be objective in extending credit to issuers of the commercial paper placed by the holding company. In its approval orders for individual banking institutions to sell or place commercial paper, the Federal Reserve specified controls necessary to control conflicts of interest and limit potential abuses. For example, the Federal Reserve required that neither the holding company nor any of its affiliates extend credit, through loans, letters of credit, or other guarantees, to support the creditworthiness or marketability of commercial paper placed by the holding company.

The Federal Reserve has also denied some additional powers due to the potential for pervasive conflicts of interest. For example, the Federal Reserve refused to allow a large bank holding company to provide credit ratings on bonds, preferred stock, and commercial paper. The Federal Reserve decided that the provision of such ratings by a major lending organization could involve pervasive conflicts of interest.

OCC likewise considers conflicts of interest when reviewing applications for subsidiaries of national banks. OCC officials cite the limitations it imposed on Continental Illinois' options subsidiary as an example of how the agency deals with conflict of interest concerns (see p. 50). Furthermore, OCC requires national banks issuing securities to provide full disclosure so that investors have complete knowledge of bank operations.

In its response to our draft report, FDIC cited section 337.4 of its regulations as a specific example of how FDIC addresses conflicts of interest. To control potential abuses, the agency limits securities activities of subsidiaries of insured non-member banks and transactions between banks and

affiliated securities companies through its Regulation 337.4. That regulation describes allowable and non-allowable relationships, as well as the types of securities in which the affiliate can deal.

Factors Controlling Conflicts of Interest Cannot Prevent All Abuses

According to literature reviewed and bankers, regulators, and experts interviewed, the combination of competition, internal controls, and regulatory oversight serves to control conflicts of interest and limit abuses. However, these factors cannot prevent all abuses. Even in a competitive market, some abuses may still occur. According to experts, instances of abuse may occur because the costs of attempting to prevent all abuses may be greater than the resulting benefits. At some point, increased internal controls and regulatory oversight may hamper a banking institution's operations and increase consumers' costs for banking services. As a result, even if preventing all abuses were possible, the effort may not be worth the additional costs to regulators, banks, and consumers. Chapter 3 discusses the current extent of institutional conflict of interest abuses and the potential for institutional abuse if banking institutions are granted expanded securities powers.

Conflicts of Interest: Little Indication of Abuse

For the most part, bankers, regulators, and experts whom we interviewed believed that existing institutional conflicts of interest are adequately controlled. In their view, while instances of abuse may occur, abuses of institutional conflicts of interest are neither significant nor widespread. A review of selected federal banking examination reports for most banking institutions in our sample did not reveal instances of widespread abuse to contradict their assessment. Consumer complaint data were of limited usefulness in assessing the extent of conflict of interest abuses.

Under expanded securities powers, conflicts of interest in banking institutions may increase, thereby increasing the potential for abuse. However, we believe it is not possible to know in advance whether actual abuses would necessarily increase or whether existing control mechanisms would continue to be adequate if banking institutions are granted expanded securities powers. Nevertheless, bankers, regulators, and experts whom we interviewed believed the combination of competitive market forces, internal control systems, and regulatory oversight, with some adjustments such as increased examiner training and possibly additional resources, would be adequate to control banking conflicts of interest and limit abuse under expanded powers.

No Apparent Reason to Believe Institutional Conflicts of Interest and Their Abuses Are Not Under Control

In an effort to determine if widespread abuse exists, we asked our sample of bankers, regulators, and experts to provide their perceptions of the extent of current abuse. We then reviewed selected federal bank examination reports and consumer complaint data for any evidence of abuses. The consensus view of those bankers, regulators, and experts interviewed was that conflict of interest abuses by banking institutions are not a systemic problem; that is, while abuses may occur, they are not widespread throughout the banking industry. Examination reports for most sample banking institutions and the limited information provided by consumer complaints revealed little to refute their assessment.

Bankers, Regulators, and Experts Believe Conflict of Interest Abuse Is Not a Problem

The bankers we interviewed generally viewed institutional conflict of interest abuses as being very much under control. In addition, 15 experts said that abuse of conflicts of interest is not a significant problem. However, two experts expressed concern that conflicts of interest between the bank and the federal deposit insurer, which threaten bank safety and soundness, are a significant problem (12 of the 29 experts interviewed did not comment). Examples of conflicts of interest with the deposit insurer surfaced during the 1970s when bank holding companies

sponsored real estate investment trusts and during October 1987, when Continental Illinois Bank increased its financial commitment to its options subsidiary in excess of allowable limits (see discussion on pp. 11, 12, 50 and 51). As OCC officials pointed out, however, these kinds of activities present no more risk to the depositor and, ultimately, the deposit insurer than does improper handling of other more traditional activities, e.g., imprudent lending policies.

Federal and state banking regulators also said institutional conflicts of interest in banks and their holding companies are under control and abuses are not a widespread problem. Representatives of 20 regulatory offices visited did not consider institutional conflicts of interest a serious problem. Two, however, commented that conflicts of interest are a significant concern to regulators (five offices visited did not comment).

Although institutional conflicts of interest in banking are perceived as being under control, regulators and experts provided additional insight about the existing potential for abuse. Institutional conflicts of interest increase with the diversity and complexity of banking operations. When banks, for example, began advising customers on merger and acquisition issues, new conflicts of interest and therefore new opportunities for abuse arose.

Regulators and experts indicated that abuses, both institutional and personal, are less likely to occur in large banks, due to extensive internal control systems and internal audit department monitoring of conflicts of interest and potential abuses. Similarly, regulators and experts observed that small banks, while not having the same number and types of institutional conflicts of interest, are more susceptible to abuses by individuals within the bank due to less extensive internal controls including internal audit staffs. Furthermore, one regulator added that small banks are less able to survive losses resulting from conflict of interest abuses. One expert, however, believed breakdowns in conflict of interest controls for trust activities will occur more often in larger institutions where there is "too much to control."

While not the focus of this report, personal abuses have been a contributing factor in recent bank failures. A recent OCC study of 171 national banks failing from 1979 to 1987 indicated that insider abuses were present in approximately 58 percent of the national bank failures. Moreover, insider abuses contributed to about one-third of those bank failures. Material fraud also played a significant role in 11 percent of the failures. Preliminary findings from our study of 184 bank failures in

1987 indicate that insider abuses, while not cited by regulators as the sole factor in any failure, were present in over 50 percent of the bank failures.

Selected Federal Examination Reports for Most Sample Banking Institutions Did Not Indicate Substantial Abuses

In a review of selected federal examination reports for 15 of the 19 domestic banking institutions in our sample, we found the reports did not indicate any substantial abuses.¹ However, examiners noted three violations of banking laws and regulations. Although not specifically identified as such, these may represent conflict of interest abuses. Since our sample of banking institutions is not a statistically representative sample of the industry, we cannot generalize about abuses by other banking institutions.

Federal examination reports in our sample did not indicate the type and detail of steps taken to detect any conflict of interest problems. Also, examination reports did not generally document steps taken to determine the absence of problems. And we did not review workpapers associated with examination reports to determine whether testing for conflicts of interest was adequate to detect abuses.

From our review of Federal Reserve inspection reports for 15 bank holding companies which owned 15 of the 19 domestic banks in our sample, we found the reports revealed no clear indication of systemic abuse. However, the 15 inspection reports for the period between August 1985 and April 1987 revealed that three of the holding companies' subsidiary banks had—in some cases more than once—extended credit to or allowed affiliates account overdrafts for excessive amounts.² In follow-up discussions with Federal Reserve examiners, representatives of the three holding companies disagreed with the regulatory examiners' findings of any violations. According to the holding companies, the transactions in question were accidental, short-term occurrences which were corrected promptly upon detection by banking management.

From our review of 10 OCC examination reports filed with the Federal Reserve reports for the period between June 1984 and March 1987,

¹In total, we reviewed a combination of 37 federal examination reports which covered 15 of the 19 domestic banking institutions in our sample. The number of reports does not add to the number of institutions since several banks were examined more than once.

²Under Section 23A of the Federal Reserve Act, loans or extensions of credit to the affiliate, purchases of investment securities of the affiliate, or the transfer of assets between the bank and the affiliate are limited for transactions involving any one affiliate to 10 percent of the bank's capital stock and to 20 percent of the bank's capital stock and surplus for all affiliates combined.

which covered nine banking institutions in our sample, we found these reports did not indicate conflict of interest problems of either an institutional or personal nature. Also, a review of seven Federal Reserve examinations for 1985 and 1986 did not reveal any indication of conflict of interest problems for five banking institutions in our sample.

We also reviewed five OCC examination reports on a variety of overseas operations of five international banks based in the United States, which covered four of the nine domestic banks with multinational operations in our sample. The OCC reports for these banks also revealed no conflict of interest problems. OCC did criticize two of the five banks for their failure to have in place conflict of interest policies even though the banks are not legally required to have such policies.

Consumer Complaint Systems Were of Limited Use in Identifying Conflict of Interest Abuses

In our efforts to assess the extent of institutional conflict of interest abuses, we found consumer complaint information of limited usefulness due to limited statistics, difficulties in determining if a complaint involves a conflict of interest, and consumers' use of other means of recourse. Appendix IV describes the consumer complaint systems operated by FDIC, Federal Reserve, and OCC. From our review of these complaint information systems, we found that statistics about the number of complaints involving conflicts of interest were limited and possibly unreliable. The Federal Reserve did not have a complaint category for conflicts of interest. Also, OCC's and FDIC's conflict of interest categories were generally defined as complaints involving personal conflict abuses by bank employees and insider self-dealing.

According to regulatory officials, complaints involving conflict abuses may not be classified as such due to difficulties in determining if complaints involve conflicts of interest. Officials at the Federal Reserve, OCC, and FDIC said that complaint processing staff can classify a complaint by the specific banking practice questioned by the consumer. However, unless a consumer clearly alleges a conflict of interest, complaint processing staff would have to make a judgment call as to whether or not a complaint involves a conflict of interest.

Finally, officials responsible for the complaint systems at OCC, FDIC, and Federal Reserve said consumers may choose not to submit complaints about conflicts of interest. Other means of recourse available to consumers include litigation and reporting alleged violations to the local district attorney or other authorities.

Conflicts of Interest and Their Abuses Under Expanded Securities Powers

In recent years, substantial changes have occurred in the activities of banking institutions as Congress and the regulators have granted some expanded banking powers and the courts have interpreted existing laws to allow other expanded activities. Major questions remain in the debate over additional securities powers for banking institutions:

- Will the numbers and types of conflicts of interest increase as banking institutions are granted expanded powers?
- Will an increase in conflict of interest situations increase the occurrence of abuses?
- How could an increase in conflicts of interest be controlled to limit abuses?
- Will the benefits resulting from expanded powers outweigh the costs of abuses which might occur?

According to literature reviewed and some bankers, regulators, and experts interviewed, as banking institutions gain expanded securities powers, the increased diversity of banking activities may result in more conflicts of interest within banking institutions. Since a conflict of interest represents an opportunity for abuse, an increase in conflict situations would increase the potential for abuse. At the same time, expanded securities powers for banking institutions would also increase competition in the financial services industry, thereby reducing the potential for abuse. As a result, not all those interviewed agreed that an increase in conflict situations resulting from expanded securities powers would necessarily lead to an increase in actual abuses.

Banker Views

Bankers representing 12 banking institutions did not believe that bank expansion into the securities industry would increase the instances of conflicts of interest within banking institutions. However, six disagreed, believing that additional conflicts would arise. (Four of the 22 institutions we visited did not comment.) Two of the dissenting bankers indicated that no new types of conflicts would arise. Rather, resultant conflicts would resemble ones already existing in banking. One said, "In fact, the conflicts of interest commonly cited are no different than those successfully controlled without . . . loss of public confidence by banking institutions today."

Fourteen bank representatives indicated that, even if conflicts of interest increase as banking activities expand, banking internal controls would be adequate to address any increase. However, two bankers believed stronger internal controls would be necessary to control any

increase in conflict situations. (Six bankers did not comment.) Eighteen bank representatives who commented were evenly divided on whether current regulatory oversight adequately addresses the conflict of interest issue. (Four bank representatives did not comment.)

Most of the bankers said they have no intention of altering their approach to doing business and serving customers even if they engage in securities-related activities. One banker explained that banks would tailor their securities activities to conform to the needs of the banking industry.

Regulator Views

Regulators have a somewhat different view of the potential for conflicts of interest and related abuse within banking institutions with expanded securities activities. Commenting on the incidence of conflict situations, 11 regulators said conflicts of interest would increase if banking institutions are granted expanded securities activities, while five did not believe that conflicts would increase. (Eleven regulators did not comment.) While none of the regulators commented that abuses would necessarily increase, eight regulators believed that expanded securities activities would generate problems for the regulators in controlling conflicts of interest, while 12 other regulators did not anticipate any such problems. (Seven regulators did not comment.)

Federal regulators interviewed in our sample believed present oversight programs are generally adequate for controlling conflicts of interest and limiting abuses. (See app. III for additional details regarding federal regulatory oversight by the Federal Reserve, FDIC, and OCC.) However, some federal regulatory officials questioned whether they would have enough staff and expertise to carry out the same level of supervision if banking institutions were to take on new activities. Regulatory personnel indicated that, at the very least, additional training would be necessary to familiarize bank examiners with securities activities and how to address related conflicts of interest.

We also solicited views from state banking regulators since their banks were generally smaller than federally chartered ones and appeared less likely to undertake securities activities. The eight state banking regulators with whom we spoke had differing views on how they would deal with increased securities activities by banking institutions. For example, one state indicated that even though its state-chartered banks already had expanded securities powers, it had not presented a regulatory problem and involved no significant variations in their supervisory

approach. However, most state-chartered banks in that state were small and unwilling to involve themselves in securities-related activities. Even the larger banks with such activities were involved in a limited manner, presenting no real supervisory problems. Another regulator indicated that more safeguards would be required, including the monitoring of stock activity through surveillance and intelligence-gathering activities. A third regulator said that verification procedures would be necessary to help the regulators supervise.

Expert Views

Experts who commented were evenly divided on whether the potential for conflicts of interest and their abuses would increase if banking institutions were to be given extended securities powers. (See app. II for a list of experts whom we interviewed.) Of the 14 who commented, 7 felt that the potential for conflicts of interest and resulting abuses would increase, while 6 felt that the potential would decrease, and one believed it would stay the same.

These mixed results may be due to the counteracting effects of opposing forces cited by the experts. First, expanded securities powers would increase the number of conflicts of interest within banking, thus increasing the opportunity for abuses. However, at the same time, expanded securities powers would also reinforce and increase competition in the financial services industry, thus decreasing the incentive for abuses. In addition, some experts mentioned that current safeguards which did not exist before the passage of the Glass-Steagall Act, such as disclosure requirements, antitrust statutes, and regulatory supervision to monitor compliance, would adequately control conflicts and limit abuses stemming from extended activities. All 24 experts who commented said that banking organizations should be allowed extended securities activities because the benefits to consumers of increased competition would outweigh the costs of potential abuses of conflicts of interest.

Experts offered suggestions for improving regulatory oversight to minimize abuses both currently and under expanded securities powers. One expert agreed with the current practice that the role of regulators should be to verify the ability of banking institutions' internal controls to manage conflicts because regulators themselves have neither the detailed knowledge of operations nor the resources to directly monitor transactions as do banking institutions. Another expert, however, said regulators may be able to make better use of existing data collected from banking institutions to analyze what is occurring within the bank. In addition, this expert suggested that bank trust departments report all

situations where the bank has a significant relationship with the customer and holds large amounts of that customer's securities. Other experts expressed concerns about inadequate staffing levels currently hampering regulators' ability to adequately supervise. This led them to be concerned about regulators' ability to adequately supervise additional nonbank activities. Nine experts commented that stricter and more effective enforcement of laws and regulations as well as increased penalties for conflict of interest abuses is needed to deter personal abuses such as fraud and self-dealing.

Several experts cited the banking regulators' own conflict of interest between concern for safety and soundness of the bank and concern for safeguarding consumers' interests. They said this might hamper current enforcement efforts against abuses as well as those that would be needed if securities powers are extended. For example, if a regulator emphasized bank soundness, it might overlook practices that favor the bank at the expense of the consumer.

Sixteen experts suggested that to protect the deposit insurance fund from risks associated with extended securities activities, these activities be done in a separate subsidiary of the bank holding company and not in the bank. However, two experts said attempts to insulate the bank in such a manner would not reduce risks associated with expanded securities powers because the incentives to abuse remain the same no matter where expanded powers are located in the banking organization.

As for which federal regulator should supervise expanded securities powers for banking institutions, the 10 experts who expressed a preference were evenly divided between the Securities and Exchange Commission (SEC) and the banking regulators. Reasons cited were that SEC supervision would facilitate functional regulation while supervision by bank regulators would provide for fuller supervisory coverage. Of those suggesting bank regulators, two believed the Federal Reserve should supervise because of its experience in approving and supervising nonbank activities for bank holding companies. However, the other three believed that other banking regulators, not the Federal Reserve, should supervise. Two of these three specifically suggested FDIC because of its role as the deposit insurer. In this way, it could better control risk to the deposit insurance fund. The two experts who favored Federal Reserve supervision also suggested a supervisory team combining the expertise of the banking and securities regulators with the Federal Reserve as the primary supervisor.

Conclusions

The consensus view of bankers, regulators, and experts interviewed was that, while instances of abuse may occur, institutional abuses of conflicts of interest currently are not a significant, widespread problem in the banking industry. However, institutional conflicts of interest and opportunities for abuses may increase if banking institutions are granted expanded securities powers. It is not possible, we believe, to anticipate in advance whether actual abuses of those conflict situations would necessarily increase. Nevertheless, given the harm that could result to consumers and, ultimately, to banking safety and soundness from abuses, the potential for future abuses warrants close attention if banking institutions are granted expanded securities powers.

Bankers, regulators, and experts whom we interviewed believed the combination of competitive market forces, internal control systems and regulatory oversight would generally continue to adequately control banking conflicts of interest and limit abuse under expanded powers. However, even with the various adjustments suggested by regulators and experts, we believe it is not possible to predict how the expansion of securities powers for banking institutions would affect the actual extent of institutional conflict of interest abuses. While the confidence of bankers, regulators, and experts was reassuring, the expansion of banking institutions' securities powers requires the regulators to ensure that resources and procedures are adequate to exercise active oversight.

Actual and Potential Institutional Conflicts of Interest in Banking

We present here a number of institutional conflicts of interest and related abuses that we identified through reviewing literature and in discussions with academic experts, bankers, and regulators. While this is not meant to be an exhaustive listing, included are potential conflicts which might occur if banks were to obtain additional securities powers as well as conflicts present in banking today. A number of abuses arising from the conflicts listed below are already prohibited by law or regulation.

We have grouped these conflicts and associated abuses into three broad categories: conflicts with customers, conflicts with stockholders and creditors, and conflicts with the deposit insurer.

Customer Conflicts of Interest

A banking institution and its employees routinely encounter situations in which their interests would be better served by actions not in the best interest of the customer. This may occur when the banking institution has a “salesman’s stake” in promoting products or services while at the same time purporting to provide disinterested or objective advice. In addition, the banking institution could abuse customer interests by misusing information provided by the customer, requiring the customer to purchase a tied-in product, or giving preferred treatment to certain customers.

Salesman’s Stake

The following are examples of how the banking institution could derive a direct benefit by abusing customers’ interests when both providing advice and promoting products and services:

- Place a trust customer’s funds into a low or noninterest-bearing account or an inappropriate investment.
- Purchase for trust accounts unsold securities that are being underwritten or marketed by another unit of the bank or holding company. Such decisions could increase the earnings of the commercial side of the bank while possibly burdening the trust accounts with less than the best available or most appropriate investments.
- Require the trust department to deal with the bank’s brokerage affiliate in order to generate profits for that affiliate, e.g., through higher brokerage fees.
- Trade trust department assets an unnecessarily high number of times (called “churning”) in order to generate excessive fees for the bank.
- Vote trust department shares to further the bank’s own interest at the expense of the trust accounts. For example, when controlling interests in

closely held companies come into a trust department, the bank has an interest in keeping control in the hands of the management that it hopes will remain a "friend of the bank." This may conflict with the interests of trust beneficiaries.

- Conduct transactions with bank-sponsored and managed REITs that benefit the bank at the expense of the REIT shareholder. The bank could maintain substantial cash balances in the REIT's checking account, paying little or no interest; channel REIT loans to developers having profitable relations with the bank; or advantageously transfer assets from the REIT to itself.
- Buy or sell securities or advise customers for the purpose of assisting the firm's own trading, marketmaking, or underwriting activities rather than serving the customer's best interest. Using a bank-managed mutual fund as an example, a banking institution could provide biased investment advice or require the purchase of securities issued by a correspondent bank.
- Use the bank's securities affiliate to issue or market new securities to repay unprofitable loans carried by the bank.
- Delay the selling of securities from customer accounts so as to cushion the effect on the stock price and prevent default on loan payments to the bank by the firm which issued the stock.
- Provide both advising and underwriting services to merger and acquisition customers. The bank or holding company may impair its provision of disinterested financial advice.

Informational Conflicts

A banking institution could abuse customers' interests by misusing confidential information supplied by customers. The following are various conflicts and associated abuses which may arise:

- The bank's commercial department, through years of contact with customers, possesses confidential financial, managerial, and product information that could be very useful to the bank's trust department making investment decisions for trust accounts or for the investment advisors giving investment advice.
- The mergers and acquisitions unit could benefit from access to confidential commercial department customer information when advising other clients on possible takeover targets.
- The bank could aid a customer in competition with another bank customer by providing confidential credit information.
- Trust and investment advisory units could use confidential information gleaned from the files of the mergers and acquisitions department in

order to determine the future value of securities to be traded for the bank's own account or for other customers.

- Confidential information regarding current and past bank customers could be used in a manner not agreed to by the customers to provide advantages to a bank's holding company in future dealings with those customers.

Economic Tie-Ins

An involuntary tie-in occurs when in order to purchase a desired product or service a customer must also purchase an unwanted product or service. Such a tie-in can injure the customer (or others doing business with the banking institution) and become abusive when competition is lacking because the customer is not able to easily transfer his business to an alternative supplier offering better terms.¹ Examples of involuntary tie-ins follow:

- In order to obtain a loan, a customer could be required to do all his personal banking with the same institution.
- In order to obtain a loan, a customer could be required to purchase credit life insurance from the bank's insurance affiliate.
- In order to do business with a banking institution, a commercial customer could be required to place its pension fund under the management of the bank's trust department, possibly at a below market rate of return.
- In order to obtain merger and acquisition advisory services, a customer could be required to obtain financing from the banking institution. The customer might otherwise be able to obtain less expensive financing. In addition, since the banking institution now has an interest in receiving a return on its investment, it may no longer provide the customer with the most objective advice.
- In order to do business with a banking institution, a supplier could be required to maintain a deposit account or to refrain from doing business with competitors of the bank, of its holding company affiliates, or of a favored customer of the banking institution.
- In order to receive brokerage business from a trust department, a broker could be required to maintain a deposit account at the bank.

¹On the other hand, a customer is not harmed if the additional purchase is merely an option, but not a requirement. In fact, a customer can benefit if a firm uses a voluntary tie-in to pass on savings resulting from economies of scope realized through joint production of products or services.

Customer Favoritism

A banking institution could abuse customers' interests and derive an indirect benefit by giving preferential treatment to certain customers who are perhaps larger, more influential, or more profitable to the bank. A bank or holding company could take a number of actions to favor one customer over another.

- Place the preferred customer "in line" ahead of others to obtain a better price when purchasing securities.
- Provide important information to the preferred customer rather than to all.
- Lower the trust department's custodial fee to a favored commercial bank customer.
- Support the price of stock issued by the preferred customer by purchasing for trust or other customer accounts.
- Purchase, on behalf of fiduciary customers, the entire amount of a private placement from a favored customer. Since no market price is established, an abuse may be difficult to detect or prove.
- Maintain the market price of preferred customer-issued securities by not selling such securities from trust or other customer accounts despite adverse financial information.
- Buy or sell securities for trust or other customer accounts to benefit the stock acquisition or sale plans of a major customer.
- Manage similarly situated multiple fiduciary accounts in such a manner so as to consistently accord the most favorable treatment to certain accounts only (for example, in regard to "place in line" for execution of stock transactions or allocation of block stock transactions where the block is of insufficient size to be allocated to all accounts.)
- Vote trust department shares to further the interests of a preferred customer at the expense of the trust accounts.
- Manage pension fund assets for the benefit of the company sponsor instead of the beneficiaries.
- Act as trustee for bondholders while having another business relationship with the bond-issuing customer. The bank could find itself in the position of having to press for bankruptcy and liquidation in the bondholders' interest while struggling to keep the company afloat to repay bank loans.
- Accommodate a favored customer in the disposition of assets from estates and closed corporations. The beneficiaries of these trust assets—personal property, real estate, and control holdings in small corporations—may be less sophisticated.
- Give preferred consideration, including granting of loans, to customers of nonbank affiliates of the bank.

- Discriminate in the allocation of credit to, or purchasing of securities issued by, competitors either of the bank's nonbank affiliates or of favored customers.
- Make credit decisions based upon trust department account status to enhance the value of such accounts.
- Represent customers from both sides of a merger or acquisition. The banking institution could provide confidential information about one of the customers to the other.

Conflicts With Stockholders and Creditors

As with any other type of business, the banking institution also experiences conflicts of interest with its owners or stockholders and those with whom it has a business relationship, such as creditors. Such conflicts can occur when managers view their interests as being those of the bank's. In such situations the managers may see a personal advantage in taking the bank along a course of action conflicting with the owners' or creditors' interests. Further, the banking institution can use creditor funds in a manner inconsistent with creditors' expectations. Examples of this conflict and associated abuses follow.

- When managerial compensation is linked to current or short-term profits, the managers may take a course of action which increases short-term profits at the expense of longer term total profits. For example, a bank officer might approve loans with high up-front fees but with poor long-term repayment prospects.
- Subsequent to increasing capital by selling of holding company debt, the banking institution could invest in higher risk activities in the hope of increasing expected profits. The owners would receive increased profits while the creditor or debt holder would bear more risks than initially anticipated without increased return.

Conflicts With the Deposit Insurer

A banking institution has an incentive to increase its own return while increasing the risk to the deposit insurer. This can be done either directly by increasing the risk of the bank or indirectly by transferring risk from the affiliates or subsidizing affiliates' risky activities. Examples of such situations follow:

- Loans to affiliates at favorable, nonmarket lending rates or without applying appropriate credit standards.
- Loans to a customer for the purpose of facilitating the purchase of securities underwritten by a bank affiliate. In order to encourage the customer to buy, excessively favorable credit terms could be granted.

Alternatively, the customer's loan collateral could be inflated above the actual value to support the amount of the loan.

- Purchases of securities the affiliate is selling—creating “strong” demand to support an artificial market value.
- Loans on favorable terms to major users of industrial revenue bonds underwritten by an affiliate in order to ensure the success of the project being financed.
- Loans on favorable terms to issuers of securities underwritten, dealt in, or recommended by an affiliate.
- Loans on favorable terms to issuers of commercial paper placed by the bank or its affiliate.
- An indirect bank subsidy to an affiliate through favorable treatment of the affiliate's creditor.
- Underwriting of affiliate securities.
- Use of lower standards in a letter of credit to support a commercial paper issue underwritten by an affiliate that would otherwise not be of prime quality in an effort to make the issue marketable.
- Loans, asset transactions, or credit enhancements for affiliates or bank-sponsored entities, such as REITs, to keep them in business.
- Lowering lending standards in order to generate a supply of loans for securitization sufficient to fully utilize the underwriting and brokerage facilities of a securities affiliate and/or to generate fee income.
- “Backscratching” with other financial institutions whereby each does transactions with the other's affiliated firm to avoid regulatory restrictions designed to control conflicts of interest and associated abuses. In this way a banking institution is able to circumvent the spirit, but not the letter, of regulations by doing transactions with “unaffiliated” firms which would otherwise not be allowed if done with affiliates.
- If management of a bank, usually a small bank, resides in one person or a small group of persons, it may have a personal interest in maximizing short-term profits especially if its compensation is tied to short-term profits. For example, managers could gain by making risky high-interest rate loans. The managers would receive the high short-term profits while the owner and deposit insurer would bear the default risk.
- Owners/managers of small banks who are affiliated with other nonbank commercial firms can acquire additional benefits of bank ownership by doing business with the bank at preferred terms.

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Appendix II
Experts Interviewed by GAO

Roy A. Schotland	Professor of Law Georgetown University Law School 600 New Jersey Ave. Washington, District of Columbia
Harold Scott	Professor of Law Harvard University International Bldg., Room 339 1557 Massachusetts Ave. Cambridge, Massachusetts
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Federal Regulatory Oversight and Efforts to Control Conflicts of Interest

Three federal agencies—the Federal Reserve System, OCC, and FDIC—share authority with state bank supervisors in a dual banking system that allows for chartering, supervision, and regulation of commercial banking organizations at both the federal and state levels. The Federal Reserve has principal supervisory responsibility for state-chartered banks that are members of the Federal Reserve System and all bank holding companies; FDIC, for insured nonmember commercial banks and insured state-chartered savings banks; OCC, for national banks.

This regulatory structure involves some overlap of responsibilities. For example, while OCC charters national banks and also has the principal responsibility for their regulation and supervision, the Federal Reserve is responsible for regulation and supervision of the Federal Reserve System and bank holding companies which own national and/or state-chartered banks. Similarly, FDIC has authority over both Federal Reserve member and nonmember banks whose deposits are federally insured. In practice, however, the three federal regulators and the states agencies have established arrangements to reduce the overlap and coordinate regulatory responsibility.

Table III.1 shows the number of institutions regulated by each federal agency as of December 31, 1987.

Table III.1: Banks Supervised by the Federal Regulatory Agencies

Dollars in millions		
	Number	Assets*
Federal Reserve		
State members of the Federal Reserve System	1,097	\$529,332
OCC		
Nationally chartered banks	4,629	1,774,542
FDIC		
State nonmember banks	8,002	697,040

*Asset information does not include 9 nationally chartered banks, 10 state member banks, and 10 state nonmember banks whose assets were not included in the regulatory reports submitted to the FDIC for the quarter ending December 31, 1987—the source of data for table III.1.

The following three sections describe the supervision and examination activities of the three federal banking agencies and their efforts to control conflicts of interest.

The Federal Reserve System's Supervision and Examination Approach

According to Federal Reserve officials, the Federal Reserve uses on-site examinations/inspections and off-site surveillance and monitoring to accomplish its goal of guaranteeing bank safety and soundness. They said the on-site examination of operations includes

- appraisal of the quality of the institution's assets;
- evaluation of management, including internal policies, operations, and procedures;
- assessment of capital, earnings, assets, liabilities, and liquidity; and
- review of compliance with applicable banking laws and regulations.

The Federal Reserve also maintains an off-site surveillance program to continually monitor the financial condition of member banks and bank holding companies through examination of financial profiles. This surveillance program supplements the examination process through computerized screening to identify institutions with poor or deteriorating financial profiles. Once a banking institution with difficulties is identified, the Federal Reserve targets that institution for further on-site examination.

How the Federal Reserve Does Examinations

Federal Reserve examinations and inspections¹ can have three different scopes: full, limited, or targeted. A full-scope examination covers all banking areas in detail. A limited examination reviews areas covered by a full-scope examination but in less detail. A targeted examination focuses on one or two activities. Federal Reserve examinations may be done either by its own personnel and/or by state banking regulator examiners. The extent to which conflicts of interest situations are addressed varies with the type of examination being done and, in the case of targeted examinations, the areas being reviewed.

Examination type and timing are primarily based on a bank's or holding company's asset size, complexity of operation, and overall financial condition. Although the actual scheduling of examinations is left to the examiner's discretion, the Federal Reserve's policy states that, in general, banking institutions for which the Federal Reserve is the primary federal supervisor are to be examined at least annually on a full-scope basis. The largest such institutions and those with significant problems are to be examined again during the year on a limited or targeted basis. The local Reserve Bank can waive the second examination for institutions it views as financially sound. As an exception to the general rule,

¹The Federal Reserve refers to the examination of a bank holding company as an inspection.

small “shell” holding companies with no known problems and low levels of debt relative to the book value of their subsidiary bank’s stock may be inspected on a more limited basis.

During calendar year 1987, the Federal Reserve had supervisory responsibility for about 1,100 state member banks and examined nearly 97 percent of these banks. For the year, the Federal Reserve reports that 835 examinations were made either individually or jointly with state personnel—some banks were examined more than once. State personnel are reported to have individually examined an additional 319 institutions.

According to one Federal Reserve official, the Federal Reserve examined each of its troubled institutions twice during calendar year 1987. These problem institutions, according to Federal Reserve officials, accounted for less than 8 percent of those banks for which the Federal Reserve has primary responsibility.

During calendar year 1987, the Federal Reserve, according to one official, was also responsible for the supervision of 6,443 bank holding companies. Although only 2,618, or nearly 41 percent, of these firms were inspected during the year, the official said that the Federal Reserve considers the agency up-to-date with its holding company inspections. The Federal Reserve sets the interval between inspections according to such factors as asset size and the complexity of holding company activities. The Federal Reserve requires that the largest bank holding companies (over \$10 billion in assets) be inspected on a full-scope basis annually and a limited or targeted inspection occur between full-scope inspections. The Federal Reserve inspection requirements diminish as the bank holding company diminishes in size and complexity. Bank holding companies with assets between \$500 million and \$10 billion are to be inspected on a full-scope basis annually, with limited or targeted inspections as needed. Noncomplex shell holding companies with assets of less than \$150 million and limited debt are to be inspected on a sample basis. The size of the sample draw varies with the actual level of debt. The local Reserve Bank decides which type of inspection will be done.

The Federal Reserve has identified 249 bank holding companies with assets over \$1 billion. In calendar year 1987, the Federal Reserve inspected 30 of these 249 holding companies twice, an additional 148 once, and the remaining 71 not at all. Of these inspections, one-third of the 50 largest holding companies were inspected twice, about two-thirds were inspected once; two were not inspected.

According to Federal Reserve budget documents, staffing dedicated to supervision and regulation have increased over the 3-year period from 1985 to 1987. The number of field examiners has increased from 835 in 1985 to 910 in 1987, and the cost of the examination program has increased from an actual expenditure of \$175.6 to an estimated \$196.2 million in the same period. We could not estimate the staff time used to control conflicts of interest and identify abuses since these efforts are an integral part of the Federal Reserve examinations and staff time spent is not reported separately.

The Federal Reserve's Efforts to Identify Conflict of Interest Abuses

Although the Federal Reserve includes the review of conflicts of interest and the identification of conflict abuses as part of its supervisory effort, the verification of bank safety and soundness is the focus of its supervision. The Federal Reserve, according to its officials, has no specific program for identifying conflict abuses. Instead of a general definition for either "conflict of interest" or "abuse" of a conflict, the Federal Reserve describes abuses in terms of bank actions that are prohibited or limited by laws and regulations. Within this context, the Federal Reserve provides its bank examiners with various procedural steps to identify possible abuses of conflicts of interest.

In general, an examiner's work is guided by various Federal Reserve examination manuals and tests of the bank's safety and soundness and compliance with the pertinent rules and regulations. Each manual addresses different types of issues and transactions and, therefore, different conflicts and possible abuses. However, the manual steps are, for the most part, oriented toward personal abuses, such as self-dealing and insider transactions, which may negatively affect the safety and soundness of a banking institution.

Federal Reserve examinations include the evaluation and testing of the internal control system of a banking institution. Internal control evaluations help determine the detail of an examination. Banking units or operations within the bank demonstrating strong controls, according to a Federal Reserve official, may receive little or no detailed testing of individual transactions within the area under review. Conversely, areas with less effective controls are to receive more extensive transactional testing.

Likewise, according to this official, when the Federal Reserve inspects bank holding companies, its personnel evaluate internal controls, especially those controls over transactions between the bank and its holding

company and affiliates. The Federal Reserve focuses on the impact that potentially risky transactions with affiliates may have upon the safety and soundness of the bank.

Since the steps that might help to identify conflict abuses are interwoven into routine examinations, the discovery of an abuse is likely to occur during such an examination. Identification of an abuse would depend on various factors including the steps the examiner is following and the areas of the bank under examination.

Despite the Federal Reserve's reliance on the bank's internal controls, an examiner may not be able to identify questionable transactions. The Federal Reserve has recognized the difficulty in identifying certain inappropriate acts. For example, the Federal Reserve's former chairman testified before Congress that monitoring transactions between affiliates is extremely difficult and section 23A of the Federal Reserve Act limitations on transactions between affiliates are not as effective in controlling abuses as the Federal Reserve would like.²

Federal Reserve officials said their training is based on the use of their examination manuals which include steps designed to examine conflict of interest situations and detect related abuses. Also, some courses demonstrate techniques for detecting particular types of conflict abuses, such as a course regarding insider abuses.

The Office of the Comptroller of the Currency's Supervision and Examination Approach

OCC's approach to bank supervision is to promote safety and soundness by requiring that national banks adhere to sound management principles and comply with banking laws and regulations. OCC views its approach as necessary to protect the national interest in a safe and stable financial system which effectively and efficiently meets customer needs. To assure adherence to its requirements, OCC does safety and soundness as well as compliance examinations.

Before January 1986, according to the Director of Commercial Activities, the OCC examination schedule was based upon the agency's numerical rating of each specific institution. This schedule was weighted so those banks with the most significant problems—and therefore worst ratings—were to be examined most frequently. The policy also provided

²Statement by Paul Volker before the Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, June 11, 1986.

for mandatory examination of even the least risky banks at some minimum interval. Subsequently, OCC chose to establish an examination system based upon a hierarchy of risk in order to more efficiently use its resources and address the increased number of troubled banks, the number of recent bank failures, and the growing complexity of the banking system in general.

Agency policy, according to one OCC official, no longer states a minimum time interval for safety and soundness examinations. Supervision of banks now blends continuous on-site and off-site activities. On-site examinations are done when examination personnel believe, based on off-site analysis, that conditions warrant. That is, on-site examinations are not just the result of a defined time consideration. OCC decided changes in the nature of banking and its technology, products, and services, as well as staffing limitations, necessitated this new supervisory approach.

Under its new approach, OCC develops a supervisory strategy for each bank. The strategies blend on-site and off-site activities based on OCC staff's assessment of the condition and stability of the individual bank. Subject to management review, individual examiners or teams of examiners define the scope of on-site and off-site supervisory activities based on various factors, including past examination results and continuous off-site analysis. Off-site surveillance includes the analysis of various internal and external financial reports, computer models, external audits, and SEC reports.

The OCC official explained that the agency on-site examinations focus on specific supervisory concerns regarding a bank's operations. On the basis of continuous off-site analysis, examiners may target on-site examination on policies, procedures, and internal controls; investments and loans; or, the relationship between the bank and its related organizations and the effect of those relationships upon the bank's soundness. Examination of all of those functions would not normally be done unless conditions warranted such supervision.

An OCC official said the agency had determined that off-site analysis needed to be augmented with on-site transaction verification and internal control testing. In April 1987, to complement its supervision, OCC began doing separate compliance examinations on a sample of banks to evaluate systemwide compliance. During such examinations, OCC examiners evaluate bank compliance with a number of laws and regulations. Under this program, OCC annually examines a sample of banks weighted

according to asset size. Once the sample of banks is established, OCC resources are allocated to do the compliance examinations of the sampled banks. Such testing measures system compliance along with the compliance of individual banks.

OCC officials consider a resident examiner approach to be a key aspect of ongoing supervision of large national banks with multinational operations. Because of the size and complexity of the operations of the 11 largest national banks, OCC's multi-national banking unit assigns a resident examiner to each of these banks to ensure continuous on-site examiner presence. In addition to on-site examination and off-site surveillance, continuous supervision of the 11 largest banks includes numerous focused examinations of specific activities such as asset quality, capital markets, and compliance through the year. The selection of targeted activities is based on decisions of the resident examiner and OCC concerns about systemic risk.

OCC said that in calendar years 1985, 1986, and 1987, it spent 1304, 1343, and 1310 staff years, respectively, on safety and soundness examinations. Likewise during the same 3 years, 41, 103, and 158 staff years were spent on compliance examinations. This was accomplished with approximately 2,200 examiners in each of the first 2 years and 2,300 in the last. We were unable to determine the amount of staff time spent addressing conflicts of interest since OCC said it does not maintain its cost statistics in such a manner. OCC officials said, however, that the agency considers that all its compliance examinations, including trust department examinations, address violations of law as well as potential conflict of interest abuses.

OCC Efforts to Control Conflicts of Interest

According to the Director of Commercial Activities, OCC does not have a specific program for monitoring conflicts of interest or identifying abuses. Agency officials indicated that assessment of conflicts of interest is an important part of both compliance and safety and soundness supervision. In particular, the compliance examination program, which includes trust departments, contains a segment which focuses on conflicts of interest and identifying insider abuse. OCC, according to one official, does not define the terms "conflict of interest" or "abuse" of such a conflict. Rather, OCC provides its examiners with special training programs, such as a "White Collar" crime seminar, and various procedures for evaluating conflicts in banking operations. Some OCC examination steps address conflict of interest issues through limits on bank conduct,

such as limits on the maximum credit that a bank may extend to an affiliate.

According to OCC officials, work steps addressing conflicts of interest and their abuses are interwoven throughout the agency's examination manuals and handbooks. Compliance examinations include the review of policies and procedures to ensure that control systems are operating, for example, to prevent preferential treatment of a bank affiliate. Additionally, during safety and soundness examinations, OCC personnel are to review transactions for potential conflicts of interest and abuses such as favorable loans to bank insiders.

According to the Director of Commercial Activities, OCC bases its supervisory efforts on the premise that a bank's performance is the responsibility of its management. The agency believes that it can best supervise national banks by requiring that the banks have policies, procedures, and internal control systems in place to ensure that their competitive efforts are consistent with safety and soundness. OCC believes that an effective system of internal controls greatly reduces the likelihood of conflict of interest abuses occurring in a bank.

Accordingly, an OCC official said the evaluation of a bank's internal control system is a major OCC method for identifying potential problems that can lead to violations of banking laws and regulations or unsafe and unsound banking practices. OCC examiners are to evaluate internal control systems through a combination of reviewing documents, observing operations, and verifying the actual operation of written procedures. OCC does not require examiners to test internal controls in all situations. Instead, OCC examiners may accept the internal control evaluations of the bank's internal or external auditors.

Despite OCC's reliance on internal controls, such controls can be circumvented. For example, during the October 1987 Stock Market Crash, Continental Illinois Bank made cash loans to its First Options subsidiary exceeding OCC's limits. In approving Continental Illinois to establish its First Options subsidiary, OCC limited the bank's participation in the subsidiary to an amount equal to 15 percent of the bank's capital. During the October 1987 Market Crash, Continental Illinois loaned its subsidiary an amount exceeding the limit without OCC approval. Within 24 hours after the transaction, OCC detected the violation and immediately ruled that the bank recover the excess amount without delay. OCC also issued an administrative cease and desist order to prevent any future violations. OCC officials believe that, while a bank may act to circumvent

controls, the Continental Illinois incident demonstrates OCC's ability to detect violations and enforce compliance.

According to OCC officials, all OCC examiners receive the same basic training and preparation, which includes conflict of interest issues. Some examiners also receive specialized training. Some of this specialized training, such as OCC's credit, trust, white collar crime, and bank security dealer courses, addresses conflict of interest abuses, particularly insider dealing. Furthermore, examiners responsible for the large money center banks receive specialized training in new bank products or services. Such specialized training programs are generally developed after the banks have engaged in these activities.

FDIC's Supervision and Examination Approach

FDIC's supervision approach includes an examination program which focuses on the safety and soundness of individual banks. According to an FDIC official, FDIC supplements its examination program with off-site monitoring and surveillance to identify banks that may require more frequent examination. Off-site monitoring includes the analysis of earnings, asset quality, capital, and liquidity to identify deteriorating performance.

How FDIC Examines

FDIC makes the following types of examinations:

- Safety and soundness examinations focus on uncovering conditions which may threaten the safety and soundness of the banks as well as on determining whether the bank adheres to banking related laws and regulations.
- Compliance and civil rights examinations address non-safety and soundness enforcement activities, such as consumer protection and civil rights.
- Trust department examinations determine if a trust department's policies or administration of accounts safeguard the trust assets or could result in any future contingent liability or estimated loss which could have an adverse impact on the bank's capital accounts.
- Electronic data processing examinations determine the validity and reliability of the records produced by the bank's automated systems. Emphasis is upon internal control systems.

An FDIC official said the frequency of examinations is based on FDIC's current staffing and agency priorities. At the time of our review, FDIC

policy stipulated that a strong bank is to be examined not less than once in 3 years, and troubled banks are to be examined annually at a minimum. A bank that falls between these extremes is to be examined not less than once in 18 months. A regional director, when he believes circumstances dictate, can extend the interval for examining a strong bank to up to 5 years.

An FDIC official said the agency has had some difficulty in meeting its examination frequency targets due to other priorities, the recent surge in bank failures, and limited staffing. The official said FDIC reevaluates examination intervals every few years. The agency now believes that the 3-year interval needs to be reduced based on the current state of the economy and the record numbers of recent bank failures. Officials report that the agency is planning to hire more examiners to reduce the average interval from 3 to 2 years.

According to an FDIC official, FDIC made 4,885, 5,390, and 7,692 examinations in 1985, 1986, and 1987 respectively. The total staff years spent on examinations by FDIC in 1985, 1986, and 1987 was 827, 1,090, and 1,299 respectively. Safety and soundness examinations represented the largest number of examinations in each of the 3 years—2,940, 3,194, and 3,653 respectively. Safety and soundness examinations also represented the biggest expenditure in terms of staff years in each of the 3 years—767, 1,018, and 1,190 respectively, an average of 92.6 percent of total examiner staff. We were unable to determine what portion of FDIC's examination staff years were spent in controlling conflicts of interest and preventing their abuse, since the FDIC does not accumulate staffing statistics for conflict of interest activity separately from other examination activities.

Internal control evaluation plays an important role in the FDIC examination of a bank. FDIC believes that management is ultimately responsible for what occurs in the bank, including the identification of abuses. The examiners are to verify that the bank has an appropriate, functioning internal control system. An FDIC official said that examiners, however, have discretion in deciding what actual steps to follow in their examinations. The examiner's opinion on the adequacy of bank policies and procedures and of past audits (internal and/or external) may affect the examination's scope.³ The degree of transaction testing is to vary directly with the results of the internal control evaluation; in other

³According to an FDIC official, at institutions with significant problems, bank examiners are more likely to do substantive examination procedures, irrespective of the existence of internal controls.

words, a better designed internal control system would receive fewer transaction tests.

FDIC's Efforts to Identify Conflicts of Interest Abuses

FDIC does not have a specific program to address conflicts of interest and their abuses. Rather, the agency has examination steps dealing with conflicts and potential abuses incorporated throughout its examination manuals. An FDIC official informed us that FDIC has not defined the terms "conflict of interest" or an "abuse" of such a conflict. Rather, FDIC provides its examiners with various examination steps that generally describe actions that a bank may not do or is permitted to do only within prescribed limits.

According to an FDIC official, while examination steps address both individual and institutional conflicts of interest, the examination steps more extensively address personal or individual abuses. These abuses are likely to occur in the smaller bank that is more representative of FDIC's inventory of banks and can lead to failure. FDIC officials believe the degree of internal control within a bank varies directly with the size of the bank. Small banks, defined by FDIC officials interviewed as banks with less than \$25 million in assets, generally are not expected to have the types or number of internal controls that large banks have.

According to an FDIC official, conflicts of interest and their abuses usually are addressed in the context of their potential impact upon a bank's safety and soundness. For example, according to this official, when reviewing transactions between a bank and an affiliate, FDIC would be more concerned with any negative impact upon the bank rather than on the affiliate. Furthermore, if a transaction benefitted the bank at the expense of the affiliate, FDIC would be directly concerned only to the extent the transaction could potentially result in a contingent liability to the bank.

Consumer Complaint Systems

As required by legislative¹ and executive mandates,² FDIC, the Federal Reserve System, and OCC process consumer complaints against banks under their jurisdiction. At each agency, an automated complaint database facilitates monitoring of complaint processing and analysis of complaint trends. The banking regulators also use complaint data in supervision and policymaking.

While complaint data are a potential source of information about areas of possible regulatory concern, we found complaint information of limited usefulness in identifying institutional conflict of interest abuses. Statistics about complaints involving conflicts of interest were limited and may not be reliable. Complaints involving conflicts of interest may not be identified as such due to difficulties in determining if a complaint involved a conflict of interest. Further, conflict of interest abuses may not result in consumer complaints, because consumers may choose instead to seek redress through other means including litigation.

Consumer Complaint Processing

FDIC, Federal Reserve, and OCC accept, investigate, and resolve consumer complaints against banks under their supervision. Within each agency's headquarters, a consumer affairs group oversees complaint processing and establishes program policies and procedures. Field offices of FDIC and OCC and individual Federal Reserve banks are responsible for investigating complaints against banks under their examination and supervision. FDIC, Federal Reserve, and OCC rely on the banks to provide explanation and/or documentation concerning most consumer complaints. Complaint investigations are done through written correspondence or over the telephone. Serious or complex complaints, such as those alleging credit discrimination or where the bank has a history of noncompliance, may be the subject of an on-site investigation. Each agency also maintains a computerized complaint database for monitoring complaint operations.

¹Magnuson-Moss Warranty—Federal Trade Commission Improvement Act of 1975 required each banking agency to have a consumer affairs division to receive and take appropriate action on complaints with respect to unfair or deceptive acts or practices by banks subject to their jurisdiction (15 U.S.C. 57a [f][1]).

²Executive Order 12160 (Sept. 26, 1979) established a Consumer Affairs Council and required federal agencies to establish procedures for systematically logging in, investigating, and responding to consumer complaints and for integrating analyses of complaints into the development of policy.

Complaint Data May Be Used in Supervision and Policymaking

In addition to monitoring complaint processing operations, FDIC, Federal Reserve, and OCC may use complaint data in supervision and policymaking.³ With its computerized complaint information system, each agency may use complaint data for the following:

- To identify concentrations and trends by bank or complaint category. An early warning feature in the Federal Reserve's complaint system flags any single complaint category with more than 15 complaints per quarter or 50 complaints per year.
- To provide referrals for examination follow-up. As a supervisory tool, examiners are to review complaints against a bank in preparing for an examination.
- To identify consumer concerns about unfair or deceptive practices and determine the need for corrective legislation or regulation.

Use of complaint data in policymaking may be illustrated by the example of delayed funds availability. In 1987, Congress passed the Expedited Funds Availability Act to restrict bank delays in crediting deposits to customer accounts. FDIC, Federal Reserve, and OCC each classify and can track consumer complaints about delayed funds availability. Pursuant to the act, the Federal Reserve promulgated new regulations requiring banks to make customers' funds available within specified time frames and also requiring banks to disclose funds availability policies to customers. The regulations were based, in part, on statistics about such complaints received by all three agencies.

Complaint Data Were of Limited Usefulness in Identifying Conflicts of Interests

In our efforts to assess the extent of institutional conflict of interest abuses, we found consumer complaint data were of limited usefulness due to 1) limited and possibly unreliable statistics, 2) difficulties in determining if a complaint involved a conflict of interest, and 3) consumers' use of alternative recourse.

Complaint information systems provided limited and possibly unreliable statistics about the number of complaints involving conflicts of interest. The Federal Reserve did not have a complaint category for conflicts of interest, because the Federal Reserve does not define the term. Although the OCC and FDIC information systems include codes for conflicts of interest, we found that the conflict of interest category was generally defined

³For a discussion of how federal banking regulators use complaint data in their supervision and policymaking, see Financial Institution Regulatory Agencies Can Make Better Use Of Consumer Complaint Information (GAO/GGD-83-31, Aug. 1983).

as complaints involving personal conflict abuses by bank employees and insider self-dealing. From 1985 through 1987, OCC identified 58 complaints alleging conflicts of interest out of nearly 38,000 written complaints, while FDIC identified 15 conflict of interest complaints out of nearly 7,440 written complaints.

However, this paucity of complaints may not be a reliable indicator of the extent of conflict of interest abuses. According to regulatory officials, complaints involving conflict abuses may not be classified as such due to difficulties in determining if complaints involve conflicts of interest. Officials at the Federal Reserve, OCC, and FDIC said that complaint processing staff can classify a complaint by the specific banking practice questioned by the consumer. However, unless a consumer clearly alleges a conflict of interest, complaint processing staff would have to make a judgment call as to whether or not a complaint involves a conflict of interest. According to a Federal Reserve official, complaint staff can easily categorize a complaint about a specific practice, such as a bank's mishandling of a trust account. However, determining whether such a trust complaint involved a conflict of interest would require a subjective judgment, and different reviewers might categorize the complaint differently.

The difficulty of determining whether a complaint involves a conflict of interest may be illustrated in the example of funds availability. Consumer groups alleged that some banks may have excessively delayed crediting customers' accounts to invest the funds for the banks' benefit. If consumers complain about the bank practice of delaying deposits without alleging that the bank used the funds in the interim for its own benefit, these complaints would not be identified as conflicts of interest. However, determining to what extent banks delayed availability to invest funds was not necessary for the regulators to correct this unfair banking practice.

Another limitation on the usefulness of complaint data in assessing the extent of conflict of interest abuses is that consumers may choose not to use the complaint system to seek redress for institutional abuses. According to officials responsible for the complaint systems at OCC, FDIC, and the Federal Reserve, consumers may choose not to submit complaints about conflicts of interest. For those abuses prohibited or limited under current banking legislation and regulation, the injured party may choose instead to report alleged violations to the local district attorney or other authorities, according to a Federal Reserve official. Also, bank shareholders or firms that are bank customers may resort to litigation to

correct their grievances. For example, if a bank's merger and acquisition unit uses confidential information obtained through the bank's commercial lending unit to assist in the takeover of a bank customer, the injured firm may choose to sue the bank rather than complain to the banking regulators.

Comments From the Federal Reserve System

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

November 14, 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for giving us the opportunity to comment on your draft report, Banking: Conflict of Interest Abuses in Commercial Banking Institutions.

See comment 1.

Chapter 2 of the report lists three factors that serve to control institutional conflicts of interest and limit abuses; competition, internal controls and regulatory oversight. The Report does not appear, however, to address adequately, if at all, statutory and regulatory restrictions and well settled common law fiduciary principles that are specifically aimed at preventing abuses arising from potential conflicts of interest. Many of the potential abuses listed in Appendix I would appear to violate one or more of these regulatory, statutory or common law principles and would thus constitute conduct that would subject an institution to civil and/or criminal penalties, or would expose it to surcharge liability. We thus believe these restrictions and principles would be appropriately discussed in the text along with other factors that work to constrain many of the conflict of interest abuses that are cited. In connection with this discussion, you may wish to review the examples of potential abuses listed in Appendix I and appropriately identify or delete those where there is little or no likelihood of them occurring.

See comment 2.

See comment 1.

As brief examples of the statutory restrictions that we have in mind, see Sec. 23A and Sec. 23B of the Federal Reserve Act (loans to affiliates), Sec. 106 of the Bank Holding Company Act (anti-tying of services or products); Sec. 5201 of the Revised Statutes (lending on own securities); Sec. 17 of the Investment Company Act of 1940 (transactions with affiliated persons) and Sec.10b of the Securities Exchange Act of 1934 (anti-fraud and anti-manipulative practices). For regulatory provisions, see order of the Board of Governors dated April 31, 1987 conditionally approving applications of Bankers Trust, Citicorp and J.P. Morgan to engage through subsidiaries in underwriting certain types of securities (73 Federal Reserve Bulletin 473) and Chinese Wall Policy statement dated March 17, 1978 (73 Fed. Reg. 12755). For common law principles, see Scott, The Law of Trusts (3rd. Ed.) Sec. 170; Bogert, Trusts (Sixth Ed.)

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Sec. 95; and Restatement of the Law of Trusts (2nd. Ed.)
Sec. 170.

See comment 3.

A few technical comments with respect to the description of Federal Reserve supervisory procedures contained in Appendix III were furnished orally to your staff on November 10, 1988.

If any of your staff would like to discuss these comments in more detail, please call Robert S. Plotkin, Assistant Director, telephone 452-2782.

Sincerely yours,



Frederick M. Struble
Associate Director

GAO Comments

1. We agree with the Federal Reserve that numerous statutory, regulatory, and common law fiduciary principles address conflicts of interest and their possible abuses and serve to help prevent such abuses. As discussed on page 9, we define an abuse of a conflict of interest as a violation of customary banking practices, fiduciary responsibilities, or banking laws and regulations. However, it was not our intention to either compile or evaluate all such laws and regulations. Rather, we studied the methods by which the regulatory agencies enforce compliance.

The existence of a law no doubt deters some violations or abuses of conflicts of interest. However, some form of enforcement is generally necessary to reinforce this deterrence and to detect and correct any violations. The three agencies discussed in this report are the primary source of enforcement for commercial banks and their related activities. In our view, their enforcement activities are as necessary to controlling abuse as the existence of the laws and regulations that they enforce.

2. Appendix I provides a listing of actual and potential conflicts of interest in banking which have existed, currently exist, or which could exist if banks were to undertake securities-type activities. As discussed above, legal prohibitions against an abuse do not guarantee that such an abuse will not occur. For example, although insider transactions are proscribed by regulation, recent OCC and GAO studies found such abuses were present in over 50 percent of recently failed banks. We therefore listed potentially abusive situations confronting commercial banking institutions regardless of the likelihood of the occurrence of a particular abuse, which is difficult to predict.

3. Federal Reserve staff made technical suggestions which were incorporated into the report to clarify or enhance discussion of that agency's regulatory approach.

Comments From the Federal Deposit Insurance Corporation

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429

Division of Bank Supervision

November 2, 1988

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review and comment on your draft report entitled "Banking: Conflict of Interest Abuses in Commercial Banking Institutions."

Staff has reviewed this report and we have no substantive comment other than to note the particular relevance of section 337.4 of FDIC regulations in the context of your report.

Section 337.4 represents a concrete example of a regulatory effort to address and control potential conflict of interest abuses in the relationship between an insured nonmember bank and its securities subsidiary. We commend it to you for possible further discussion in the report.

It is my understanding that staff has also commented verbally on a number of technical points. These comments were offered for your consideration in the interest of greater accuracy.

Sincerely,



Robert F. Miallovich
Associate Director

See comment 1.

See comment 2.

GAO Comments

1. We have incorporated FDIC's comment on pages 21 and 22.
2. FDIC staff made technical suggestions which were incorporated into the report to clarify or enhance discussion of that agency's regulatory approach.

Comments From the Office of the Comptroller of the Currency

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



**Comptroller of the Currency
Administrator of National Banks**

Washington, D.C. 20219

December 1, 1988

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review and comment on your draft report titled "Banking: Conflict of Interest Abuses in Commercial Banking Institutions." The draft provides a useful compilation of views on conflicts of interest. Conflict of interest is defined as a situation in which a person or business serving more than one interest can benefit by favoring one interest at the expense of others.

While we generally agree with the broad definition of "conflict," we are concerned that the draft report's classification of conflicts into, among other things, conflicts with the federal deposit insurance fund and conflicts with a bank's creditors and shareholders is overbroad. If it is true that deposit insurance might encourage a bank to engage in risky activities, this is a problem that is not unique to bank securities activities; it would also be present in the most "traditional" bank lending and deposit-taking activities. By the same token, a bank's conflicts with shareholders and creditors is a problem which arises out of the fact that a bank is organized as a corporation, and not as a result of the bank's business operations. In other words, the fact that a bank may engage in actions contrary to the interests of these persons is true for all corporations, and is not a concern unique to banks.

The overbreadth of the report's conflicts classifications creates what we think is an inaccurate impression that bank securities activities give rise to classes of special conflicts which are not present in other banking activities. We think it is important to understand that conflict situations arise during the course of many banking operations, including those which have long been accepted as part of the traditional business of banking. Moreover, conflicts also arise in many, if not all, types of nonbanking corporate activities. In our view, the report would benefit significantly if these points were made more strongly.

See comment 1.

See comment 2.

See comment 1.

**Appendix VII
Comments From the Office of the
Comptroller of the Currency**

See comment 3.

We generally concur with the draft's conclusion that as more products are offered, the possibility of conflicts of interest being present increases, which in turn may increase the possibility for abuse. However, we do not believe that this is a reason not to pursue expanded securities powers. We share the view that competition is important as a means of controlling the abuse of conflicts of interest. We also acknowledge that controls cannot eliminate all incidents of abuse, and that even if elimination of all abuses was possible, the cost of doing so might exceed the benefits.

See comment 4.

We appreciated the opportunity to meet with your evaluators to discuss our views with respect to conflicts of interest and to clarify the draft's description of OCC's approach to bank supervision.

Sincerely,



Judith A. Walter
Senior Deputy Comptroller for Administration

GAO Comments

1. We agree with OCC that conflicts of interest with the deposit insurer and potential abuses are not unique to securities-related activities of banking institutions. For this reason, our list in appendix I contains examples of conflicts of interest in traditional banking activities as well as those conflicts that might arise if banks undertake securities-related activities. The example on page 36 that a bank may make loans to affiliates at favorable, nonmarket lending rates or without applying appropriate credit standards illustrates a conflict with the deposit insurer in a “traditional” banking activity.
2. We agree with OCC that conflicts with creditors and shareholders result from a bank’s organizational structure rather than from its banking operations. As our report indicates on pages 10, 11, and 36, such conflicts exist in other businesses with comparable structures and are not unique to banking institutions.
3. The report does not suggest nor, do we believe, leave the impression that the increased potential for conflicts of interest and their abuses resulting from banks’ expanded activities is, by itself, a basis for denying additional powers.
4. OCC staff made technical suggestions which were incorporated into the report to clarify or enhance discussion of that agency’s regulatory approach.

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Glossary

Affiliate	Any related company. May refer to a parent company, subsidiary, or sister subsidiary.
Bank Call Report	Statement of financial condition of a bank submitted to supervisory authorities.
Bank Department	A unit within the bank organized to perform a specific function.
Bank Holding Company	A state-chartered company that owns or controls one or more banks. Control is usually evidenced by ownership of 25 percent or more of a bank's voting stock but may also be evidenced by control over the election of a majority of the directors or by other forms of control. The Federal Reserve Board determines which activities closely related to banking may be engaged in by bank holding companies, either directly by a bank or through nonbank subsidiaries.
Banking Institution	As used in this report, refers to either a bank or a bank holding company.
Capital	<p>Finance: The net worth of a firm, i.e., the total assets of a business less the liabilities.</p> <p>Bank: As used in banking, total capital is the sum of primary and secondary capital. Primary capital includes common stock, perpetual preferred stock, undivided profits, allowance for loan losses, and other components. Secondary capital is composed of limited life preferred stock, bank subordinated notes and debentures, and unsecured long-term debt of the parent holding company and its nonbank subsidiaries.</p>
Churning	Excessive turnover of an investor's account, usually by a brokerage firm or representative, which may be motivated by the pressure to create commission income.
Collateral	Securities or other property pledged by a borrower to secure or guarantee repayment of a loan.

Glossary

Commercial Paper	Unsecured short-term promissory notes of prime business corporations maturing in less than 1 year (usually 3 to 6 months) sold through commercial paper dealers and brokers to corporate and individual investors.
Conflict of Interest	A situation where a person or firm is serving two or more interests and can benefit personally by placing one of those interests ahead of another.
Credit Guarantee (Or Enhancement)	(See Guarantee.)
Dealer	An individual or firm in the securities business acting as a principal rather than as an agent. The same individual or firm may function at different times as broker and dealer.
Deposit Insurance	Insurance to protect the depositor against bankruptcy of a bank or thrift institution.
Director Interlock	A condition that exists when the directors of one corporation are at the same time directors of one or more other corporations.
Efficiency	Maximum output with minimum input.
Equity	Investments: The ownership interest of common and preferred stockholders in a company.
Fiduciary	A person acting alone or jointly with others primarily for the benefit of another in all matters connected with its actions. The principal function of a fiduciary is the management of property for others.
Guarantee	A contract in which a third party, the guarantor, intervenes in an agreement between two persons by becoming responsible to one for the default of the other.

Insider	A person who, because of his employment or business connections, has intimate knowledge of the financial affairs of a concern before such information is published and is available to the public.
Insider Trading	The misappropriation of nonpublic, material information for personal or financial gain. (See also Self-dealing.)
Insider Transactions	Transactions with a concern made by insiders such as officers, directors, or major shareholders, possibly at favorable terms unavailable in the marketplace.
Insured Banks	Banks whose deposits are insured by FDIC (currently up to \$100,000 per depositor).
Joint Venture	A business or undertaking entered into on a one-time basis by two or more parties in which profits, losses, and control are shared.
Letter of Credit	<p>Instrument by which a bank substitutes its own credit for that of an individual, firm, or corporation.</p> <p>A guaranteed letter of credit, which is the usual type of commercial letter of credit, is one in which the customer guarantees payment of the amount of the draft to the credit-issuing bank at its maturity. (See also "Guarantee.")</p>
Liquidity	<p>(1) Finance: The condition of an individual or business wherein a high percentage of the assets can be quickly converted into cash without any considerable loss due to sacrifice prices.</p> <p>(2) Investments: The ability of the market in a particular security to absorb a reasonable amount of buying or selling at moderate price changes.</p>
Marketmaking	Standing ready to buy and sell particular securities at firm price quotations, especially in the over-the-counter market. This usually involves maintaining a position (inventory) in the security concerned.

Market Price	The price established in the market where buyers and sellers meet to buy and sell similar products; a price determined by factors of supply and demand.
Material Inside Information	Information is "material" when the information is such that a significant likelihood exists that a reasonable investor would think it important in making investment decisions. Information is "inside" when it has not been publicly disseminated.
Member Bank	A bank that is a member of the Federal Reserve System. All national banks are required to be members, while state chartered and mutual savings banks may elect to be members.
Money Center Bank	A large commercial bank in cities such as New York, Chicago, San Francisco, and Los Angeles that is active in the money markets.
Money Market	A market consisting of financial institutions and dealers in short-term credit.
National Bank	A commercial bank chartered and supervised by the Comptroller of the Currency. National banks are required to be members of the Federal Reserve System.
Nonbank Activities	Financial activities closely related to banking in which either banks or their nonbank affiliates may be engaged.
Nonmember Bank	A bank that is not a member of the Federal Reserve System.
Option	<p>A right to buy (call) or sell (put) a fixed amount of a given stock, commodity, or financial instrument at a specified price within a limited period of time.</p> <p>The purchaser hopes that the price will go up (if the purchaser bought a call) or down (if the purchaser bought a put) by an amount sufficient to</p>

provide a profit greater than the cost of the contract and the commission and other fees required to exercise the contract. If the price holds steady or moves in the opposite direction, the price paid for the option is lost entirely.

REIT

A real estate investment trust; a mutual fund whose portfolio is comprised of loans and investments in real estate.

Section 23A

Section 23A of the Federal Reserve Act which places restrictions on loans and dealings between member banks and their affiliates.

Securities Broker

An individual or firm that acts as an agent in buying and selling issued securities for customers. The term may also be used to refer to a "broker and dealer," a firm that also trades for its own account.

Securitization

A process whereby a group of mortgages or other loans are pooled and used as the basis for debt or equity securities sold to the public. The holders of the securities receive their principal and interest payments from the repayments made on the original pools of loans.

Self-Dealing

Financial dealing that is not at "arm's length;" for example, borrowing or lending by a bank officer primarily for his own advantage. (See also Insider Transactions, Insider Trading.)

State Bank

A bank that is organized in accordance with state law and chartered by the state.

Subsidiary

General: A corporation controlled by another corporation through partial or complete stock ownership of the voting class of security, interlocking directorate, lease, or community of interest.

Bank: A bank subsidiary, as defined by Section 23A of the Federal Reserve Act, is any company of which 25 percent or more of any class of its voting stock is owned, controlled, or may be voted by the bank; or any company with respect to which the bank controls, in any manner, the election of a majority of its directors or trustees.

Tie-In

In general, the requirement that a customer purchase one or more additional products or services as a condition of the purchase of the desired product or service.

In addition, a tie-in could also refer to the requirement that a customer provide some other product or service, or refrain from dealing with other parties, as a condition of the purchase of the desired product or service.

Trading

Buying and selling securities for a short-term period (less than 6 months) in the hope of making profits.

Underwriting

The process of guaranteeing all or part of the sale of an issue of securities by purchasing it at a stated price from the issuing corporation or governmentality. The underwriters attempt to sell the securities to the investing public at a price sufficiently attractive to ensure their sale and yet high enough to yield a profit.

In a "best efforts" type of underwriting, the underwriters make no firm commitment to purchase the securities themselves but merely use their best efforts to sell as much of the offering as possible.

Universal Banking

The selling of all financial services through a single intermediary.

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